

Lease Accounting: A Look into the Proposed Standard

An Honors Thesis (HONR 499)

by

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A handwritten signature in black ink, appearing to read 'J. Ledbetter', with a stylized, cursive script.

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Abstract

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have undertaken a joint project that may significantly impact the way leases are accounted for, if passed. The current treatment for lease accounting is very familiar to users and preparers, so if the proposed treatment is passed there will be some time needed for adjusting to the different accounting methods. These changes also have the potential to affect system and control aspects of companies that lease assets as well. Undergraduate students that are currently enrolled in accounting classes could possibly learn information that will be outdated upon their graduation and entrance into the workforce. I have outlined the current treatment for lease accounting, aspects of the proposed changes to lease accounting, a summary of concerns constituents have on the proposal, and comments from the Big Four accounting firms.

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Introduction

The purpose of this paper is to provide background on lease accounting for US GAAP and useful information on the proposed changes made through the joint lease project by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) for undergraduate accounting students. After years of discussion, in May of 2013 the FASB and IASB (the boards) issued an Exposure Draft for proposals of new treatment for lease accounting and hundreds of comment letters from preparers, users, and consultants flooded in from May to September discussing topics of support, concern, and suggestion for the proposed standard. This is currently an area of high interest in the accounting profession due to the very few amendments that have occurred in lease accounting since the 1970s, and the extensive proposal of change. According to partners at PwC, one of the Big 4 public accounting firms, “the proposed lease accounting guidance will affect almost every company and for some, the proposed changes may be significant.”¹ According to the FASB and IASB the objective of the proposal is “to increase transparency and comparability among organizations that lease assets, by recognizing assets and liabilities that arise from lease transactions.”² The leasing project was undertaken because of widespread criticisms that current leasing models failed to meet the needs of users of financial statements by not always providing a “faithful representations of leasing transactions.”³ (FIF—intro source on bookmark) The main goal of this proposal is for assets and liabilities to be recognized from a lease because currently, this is not a requirement for many lessees. As the boards progressed through these proposals they have made a lot of outreach with preparers, investors, and analysts as well as holding public roundtable meetings. Most recently, on March 18 and 19, 2014, the boards “re-

¹ *In Brief: Leasing Project Deliberations Settle Some Issues, but Differences Remain*. Issue brief. PricewaterhouseCoopers, 20 Mar. 2014. Web. 21 Mar. 2014. 2.

² Financial Accounting Standards Board. *Proposed Accounting Standards Update on Leases*. Issue brief. FASB, 16 May 2013. Web. 20 Mar. 2014.

³ Financial Accounting Standards Board. *Proposed Accounting Standards Update on Leases*. Issue brief. FASB, 16 May 2013. Web. 20 Mar. 2014.

deliberated aspects of the joint leasing project, including the lessee and lessor accounting models, lease term, and exemptions and simplifications. The boards voted on a number of items but were unable to reach consensus on certain key issues.”⁴ Currently both boards are in favor of having lessees recognize leases on their balance sheet, but they are divided on what the treatment for the income statement portion should be. Until agreements are reached, there is no final revision and no set effective date for these revisions on leases.

The scope of this paper will focus on topics most pertinent to undergraduate students and will not cover the entirety of changes that would be implemented with the 2013 Exposure Draft. The topics that have been deemed most significant to the target audience include the new classification guidance, the lessee model, and the financial statement impacts of the proposals. In regard to these topics, there will be summaries covering the treatment under the current standard, the proposed standard, and concerns constituents have on the exposure draft.

⁴ *In Brief: Leasing Project Deliberations Settle Some Issues, but Differences Remain*. Issue brief. PricewaterhouseCoopers, 20 Mar. 2014. Web. 21 Mar. 2014. 1.

Current Accounting for Leasing

The following information is the current requirements for lease accounting. Topic 840 can be found in the FASB Codification. Due to the immense amount of detail that is included in the FASB standard this is just a summary of some of the main segments addressed in the standard that are most relevant to undergraduate students. This section will be presented in outline form to ease the readability and organization of the topics in this section.

Key Definitions

1. Definitions according to ASC 840-10-20⁵
 - a. Lease: An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.
 - b. Lease inception: The date of the lease agreement or commitment, if earlier. For purposes of this definition, a commitment shall be in writing, signed by the parties in interest to the transaction, and shall specifically set forth the principal provisions of the transaction. If any of the principal provisions are yet to be negotiated, such a preliminary agreement or commitment does not qualify for purposes of this definition.
 - c. Bargain purchase option: A provision allowing the lessee, at his option, to purchase the leased property for a price that is sufficiently lower than the expected fair value of the property at the date the option becomes exercisable that exercise of the option appears, at lease inception, to be reasonably assured.

⁵ Financial Accounting Standards Board. *Accounting Standards Codification: Topic 840, Leases*. Rep. Financial Accounting Standards Board, n.d. Web. 27 Mar. 2014.

- d. Bargain renewal option: A provision allowing the lessee, at his option, to renew the lease for a rental sufficiently lower than the fair rental of the property at the date the option becomes exercisable that exercise of the option appears, at lease inception, to be reasonably assured. Fair rental of a property in this context shall mean the expected rental for equivalent property under similar terms and conditions.
- e. Estimated economic life The estimated remaining period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at lease inception, without limitation by the lease term.

Classification of Leases

2. Classification of Leases

- a. Lessee standpoint:
 - i. Capital Leases: Leases which meet one or more of the criteria in paragraph 3)a following
 - ii. Operating Leases: All other leases (those not classified as capital leases)

Criteria for lease classification

3. Criteria for lease classification according to ASC 840-10-25-1⁶

- a. If a lease agreement meets one or more of the following criteria it shall be classified as a capital lease agreement on the books of the lessee.
 - i. Lease transfers ownership of property in agreement to lessee at the end of the lease term.
 - ii. The lease contains a bargain purchase option (defined above in paragraph 1)c.).

⁶ Financial Accounting Standards Board. *Accounting Standards Codification: Topic 840, Leases*. Rep. Financial Accounting Standards Board, n.d. Web. 27 Mar. 2014.

- iii. The lease term contains 75 percent or more of the estimated economic life of the leased property. This criterion cannot be used if the beginning of the lease term falls within the last 25 percent of the total economic life of the property being leased.
- iv. Minimum lease payments. The present value at the beginning of the lease term of the minimum lease payments, excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon, equals or exceeds 90 percent of the excess of the fair value of the leased property to the lessor at lease inception over any related investment tax credit retained by the lessor and expected to be realized by the lessor. If the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.

Lessee Accounting

4. Accounting for Capital Leases by lessees

- a. According to ASC 840-30-30-1⁷ the lessee should record an asset and an obligation that is equal to the present value of the minimum lease payments at the beginning of the lease term excluding that portion of the payments representing any executory costs. Executory costs for example are insurance, maintenance, and taxes to be paid by the lessor.

⁷ Financial Accounting Standards Board. *Accounting Standards Codification: Topic 840, Leases*. Rep. Financial Accounting Standards Board, n.d. Web. 27 Mar. 2014.

- b. According to ASC 840-30-35-1⁸, The asset recorded for the capital lease should be amortized by the following:
- i. If the lease agreement includes a transfer of ownership at the end of the lease term or a bargain purchase option the lessee should amortize the asset in a way that is consistent with the way other owned assets of the lessee are amortized.
 - ii. If the lease agreement does not fit the criteria in paragraph 3)a or 3)b it should still be amortized in a way consistent with other owned assets of the lessee but the period it is amortized over should be equal to the lease term. The asset should also be amortized to its expected value at the end of the lease term.
- c. During the term of the lease, the lessee should allocate each lease payment between interest expense and a reduction of the obligation.⁹ If an extension or a renewal is made on a lease agreement that has a penalty for not renewing or a residual guarantee at the end of the agreement the asset and obligation recorded should be adjusted. This adjusted amount should equal the difference between the present value of future minimum lease payments under the revised agreement and the present balance of the obligation.¹⁰
- d. According to ASC 840-30-45-2¹¹, assets that are capital leases should be separately recognized in the lessee's balance sheet and footnotes. Obligations relating to these assets should also be recorded separately in the balance sheet and classified as current or noncurrent.

⁸ Financial Accounting Standards Board. *Accounting Standards Codification: Topic 840, Leases*. Rep. Financial Accounting Standards Board, n.d. Web. 27 Mar. 2014.

⁹ Financial Accounting Standards Board, Accounting Standards Codification: Topic 840, ASC 840-30-35-6

¹⁰ Financial Accounting Standards Board, Accounting Standards Codification: Topic 840, ASC 840-30-35-8

¹¹ Financial Accounting Standards Board, Accounting Standards Codification: Topic 840, ASC 840-30-45-2

- e. If there is a change in any of the provisions of a lease, an extension, a renewal (prior to expiration), or a termination it should be accounted for in the following way:
 - i. If modifications to the lease agreement result in changes to the remaining minimum lease payments due, the present balance of the asset and the obligation shall be adjusted by an amount equal to the difference between the present value of the future minimum lease payments under the revised/new agreement (using interest rate used on the lease initially) and the present balance of the obligation if it meets either of two criteria:
 - 1. It doesn't give rise to a new agreement
 - 2. It results in having a new agreement, but that new agreement is classified as a capital lease¹²
 - ii. Account for a lease renewal or extension in the following ways:
 - 1. If the renewal or extension is a capital lease, it should be accounted for in the ways described in the subparagraph 4)e)i)
 - 2. If the renewal or extension becomes classified as an operating lease, account for the existing lease as a capital lease until the original term is expired. Then, the renewal or extension should be accounted for as an operating lease.¹³
 - iii. If a capital lease is terminated the asset and obligation should be removed and a gain or loss should be recognized for the difference.¹⁴

5. Accounting for operating leases by lessees

¹² Financial Accounting Standards Board. *Accounting Standards Codification: Topic 840, Leases*. Rep. Financial Accounting Standards Board, n.d. Web. 27 Mar. 2014. ASC 840-30-35-19

¹³ Financial Accounting Standards Board, *Accounting Standards Codification: Topic 840, ASC 840-30-35-17*

¹⁴ Financial Accounting Standards Board, *Accounting Standards Codification: Topic 840, ASC 840-30-40-1*

- a. Payments for operating leases should be expensed over the term of the lease as the payments become payable.

6. Disclosures by lessees¹⁵

- a. Capital leases
 - i. Gross amounts of assets that are recognized under capital leases.
 - ii. The future minimum lease payments due as of the balance sheet date, in total and for each of the following five fiscal years.
 - iii. The total of minimum sublease rental payments that are to be received in the future that are considered noncancellable.
 - iv. Total contingent rental payments that were incurred during each period for which an income statement was presented.
- b. Operating leases that have noncancellable lease terms greater than one year
 - i. The future minimum lease payments due as of the balance sheet date, in total and for each of the following five fiscal years.
 - ii. The total of minimum sublease rental payments that are to be received in the future that are considered noncancellable.
- c. Rental expense for operating leases for each period that an income statement is presented for should be reported. Amounts should be separated between minimum rentals, contingent rentals, and sublease rental. Only leases with terms under a month or less do not have to be included.
- d. Lessees should also provide descriptions of the leasing arrangements they are involved in that include the following:
 - i. How contingent rental payments are determined.

¹⁵ Financial Accounting Standards Board. *Accounting Standards Codification: Topic 840, Leases*. Rep. Financial Accounting Standards Board, n.d. Web. 27 Mar. 2014. ASC 840-30-50-1

- ii. If purchase options or renewal options exist and their terms.
- iii. Any restrictions regarding dividends, additional debt, and further leasing enforced by the lease agreements that are being participated in.

Proposed Accounting for Leasing

Overview

The Financial Accounting Standards Board (FASB) proposed an exposure draft in May 2013 that, if adopted, will change the standards for lease accounting. This proposal would require most lessees to record assets and liabilities for their lease agreements. The new standard would incorporate a right-of-use model that would begin to require most lessees to record their lease agreements on the balance sheet as liabilities along with corresponding right-of-use assets. Instead of classifying leases by either capital or operating, leases would be classified by either Type A or Type B to determine when and how the revenue and expenses would be recognized for the lease. No effective date has been set yet, and the FASB is still in the outreach process of developing this standard.

According to “A closer look at the new lease accounting proposal” by EY, three of the seven FASB members voted against opening the proposal up for comment. Their concerns for the proposal included (1) that the complexity of the accounting model would hinder the ability for the user to assess the lease-related cash flows’ amount and timing, (2) the creation of two types of leases, and (3) that the costs of implementing the proposal requirements would outweigh the benefits.¹⁶ This section is presented in outline form as well to ease readability and more clearly organize the topics covered.

Main considerations of proposal

1. Lease Definition

- a. The proposed definition of a lease is a bit broader than the current definition. Leases under the exposure draft would cover all leases except those that involve: leasing

¹⁶ Ernst & Young LLP. *A Closer Look at the New Lease Accounting Proposal*. Tech. Ernst & Young LLP, 23 May 2013. Web. 21 Feb. 2014. 1.

intangible assets, leasing to explore or use natural resources, leasing of biological assets. The current standard only covers leases for property, plant and equipment (PP&E), while the proposed standard would extend to cover assets other than PP&E, such as leases of inventory. However, it is likely that these other asset arrangements would not meet the definition of a lease. Under the proposal, a lease must meet two criteria: fulfilling the contract depends on the use of an identified asset, and the contract must express that the lessee has the right to control the identified asset in exchange for consideration.

- i. An identified asset is mostly consistent with the “specified asset” term in the current leasing standard, and can be either implicitly or explicitly identified in a contract. An identified asset may be a physically distinct portion of a larger asset, but an asset that is not physically distinct would not qualify as an identified asset. For example leasing a certain number of specific floors of a building would count, but the right to use a capacity portion of a fiber-optic cable would not count because it is not physically distinct.¹⁷
- ii. The following illustration is from EY’s AccountingLink in which they gave an overview of the main changes to the standard with examples for different scenarios.

1. “Scenario A:

- a. Assume that Customer X enters into a 12-year contract for the right to use a specified capacity of a supplier’s data transmission within a fiber optic cable that connects New York to London. The contract identifies three of the cable’s 20 fibers. The three

¹⁷ Ernst & Young LLP. *A Closer Look at the New Lease Accounting Proposal*. Tech. Ernst & Young LLP, 23 May 2013. Web. 21 Feb. 2014. 3.

fibers are dedicated solely to Customer X's data for the duration of the contract term.

- b. Analysis: The three fibers would be an identified asset because they are specific to the contract and are physically distinct from the other 17 fibers in the cable.

2. Scenario B:

- a. Assume the same facts as Scenario A, except that the supplier is free to use any of the 20 fibers, at any time during the contract term, to transmit any of its customers' data, including Customer X's data.
- b. Analysis: In this case, the fibers are not an identified asset because the contract allows the supplier to use a capacity portion of any of the cable's 20 fibers to fulfill its obligation to Customer X. That capacity portion is not physically distinct from the remaining capacity of the cable."¹⁸

b. Right to control use of identified asset

- i. A contract communicates the right to control an identified asset if the customer can do both of the following:

1. Direct the use of the asset

- a. This is defined by the customer's ability to make decisions that most significantly affect the economic benefits to be derived from the asset's use over the contract term.

¹⁸ Ernst & Young LLP. *A Closer Look at the New Lease Accounting Proposal*. Tech. Ernst & Young LLP, 23 May 2013. Web. 21 Feb. 2014. 3.

- i. Example: what the asset will be employed for over the term of the contract, how it is operated, who operates it.

2. Derive the benefits from the use of the asset

- a. These benefits can be obtained either directly or indirectly through primary outputs of the asset or any byproducts. When both of the following occur, a customer would not have the ability to derive the benefits from the use of the asset:
 - i. Benefits can only be obtained in conjunction with additional goods and services that are to be provided by the supplier.
 - ii. The asset is incidental to the delivery of services because it's designed to function only with other goods or services provided by the supplier ("A Closer Look" 5).¹⁹

- 1. Ex: A customer enters into an agreement with a supplier for manufacturing equipment that they can only obtain the benefits from by using a specific consumable only offered by the supplier. Therefore the machines only function with the consumables offered by the supplier.

c. Short-term lease

¹⁹ Ernst & Young LLP. *A Closer Look at the New Lease Accounting Proposal*. Tech. Ernst & Young LLP, 23 May 2013. Web. 21 Feb. 2014. 5.

- i. If a lease agreement has a maximum term length of 12 months or less, a lessee or lessor could opt to use treatment that is similar to that of the current treatment for operating leases. This maximum term would include any renewal or extensions that are possible with the lease agreement, and the reporting for these types of leasing would be categorized by asset class.²⁰
 - ii. If a lease contained a purchase option it could not be classified as a short-term lease.
- d. Separating lease and non-lease components
- i. When a contract contains lease and non-lease components, the non-lease components would be separated.
 - 1. Example: A customer enters into an agreement with a supplier to lease health care equipment for 3 years and for the supplier to provide maintenance on the equipment. The total annual lease payment is \$100,000. There are two components of the contract, first the lease of the equipment and the non-lease component for maintenance on the equipment. The customer is required to purchase the maintenance service component in order to lease the equipment, but if it is priced as a bundle and the costs are not easily separated in the contract the customer can seek what maintenance service fees are for similar equipment for the same length of time. The customer can then allocate consideration to the component that has an observable standalone price and allocate the remaining consideration to the component without an observable price. So if the annual payment as a whole is

²⁰ Ernst & Young LLP. *A Closer Look at the New Lease Accounting Proposal*. Tech. Ernst & Young LLP, 23 May 2013. Web. 21 Feb. 2014. 6.

priced at \$100,000 and the customer finds that maintenance fees for similar equipment for each year costs \$30,000, the \$30,000 would be allocated toward the non-lease component of the contracts and the remaining \$70,000 would be allocated toward the lease component each year. See subtopic (g) Allocating contract consideration below for further description on allocating consideration of contracts.

2. Lease-related executory costs are not mentioned in the current proposal. If a component of a contract does not meet the definition of a lease, it would typically be allocated a portion of the contract consideration and accounted for separately.²¹

- ii. Guidance is provided to help identify and separate lease components in contracts that contain agreements on using multiple assets. If both of the following criteria are met, an asset would be considered a separate lease agreement:

1. The lessee can benefit from the use of the asset either on its own or combined with other readily available resources
 - a. Readily available resources may contain goods or leases that are sold or leased separately by the lessor or any other supplier, or goods or services that have already been obtained from the lessor or any other transaction.
2. The underlying asset is not dependent or highly interrelated with any of the other underlying assets in the contract.

²¹ Ernst & Young LLP. *A Closer Look at the New Lease Accounting Proposal*. Tech. Ernst & Young LLP, 23 May 2013. Web. 21 Feb. 2014. 6.

- iii. Example: A lessee enters into a contract to lease a retail space that also includes a plot of adjacent land that could be developed independently of the retail space. This lease contains two components because the plot of land is neither dependent on nor highly interrelated with the retail space or vice versa. Both components can be benefited from on its own.²²
 - iv. If one or both of these components are not met, the agreement would be considered a right to use multiple assets as a single lease. It would be evaluated based on the primary asset.²³
 - v. Example: A lessee enters into a contract to lease a retail space together with surrounding land used for parking. The lessor would not lease the building without the surrounding space, and the building is intended to be used for retail operations. This contract would contain one component because the retail space is dependent on the land used for parking. The lessee wouldn't be able to benefit from the retail space without the surrounding land used for parking. In this scenario the primary asset would be considered the retail space because that is the predominant asset the lessee contracted for the right to use, and the main purpose of the surrounding land is to facilitate the lessee to obtain benefits from the retail space.²⁴
- e. Allocating contract consideration

²² Financial Accounting Standards Board. *Proposed Accounting Standards Update (Revised)*. Publication. Financial Accounting Standards Board, 16 May 2013. Web. 10 Sept. 2013. 45.

²³ Ernst & Young LLP. *A Closer Look*, 7.

²⁴ Financial Accounting Standards Board. *Proposed Accounting Standards Update (Revised)*. Publication. Financial Accounting Standards Board, 16 May 2013. Web. 10 Sept. 2013. 45.

- i. Lessors would be required to allocate the consideration in a contract between lease and non-lease components according to the proposed revenue recognition guidance.
- ii. Lessees would allocate the consideration based on a standalone-price basis. A standalone price exists if there is a price that can be identified that the lessor or similar suppliers would charge separately for a similar lease, good, or service component of a contract. Lessees would use a residual basis when observable standalone prices are available for one or more components, but not all. If one or more of the observable components without observable standalone prices are lease components, the lessee should combine them and account for them as a single lease component. If absolutely no observable standalone prices exist all of the components (lease and non-lease) should be combined and accounted for as a single lease component.²⁵

2. Concepts used to recognize and measure lease contracts

a. Significant economic incentive

- i. The proposal would require lessees and lessors to consider significant economic incentives associated with purchase options, lease renewal options, and termination options when evaluating lease terms and payments. The initial evaluation of whether a significant economic incentive exists would include consideration of all of the following:
 - 1. Existence of a purchase option or lease renewal option and the pricing associated with these options.

²⁵ Ernst & Young LLP. *A Closer Look at the New Lease Accounting Proposal*. Tech. Ernst & Young LLP, 23 May 2013. Web. 21 Feb. 2014. 8.

2. Existence of a termination option and the amount of payments for termination or nonrenewal.
3. Contingent amounts under residual value guarantees (a residual value guarantee is a guarantee made to a lessor that the value of an underlying asset returned to the lessor at the end of the lease will be at least a specified amount).²⁶
4. Costs of returning assets (either in a condition specified in the contract or to a location specified in the contract).
5. Economic penalties such as significant customization, installation, or relocation costs.
6. The importance of the asset being leased to the operations of the lessee
7. A sublease that extends beyond the noncancelable period of the head lease.²⁷

b. Lease term

- i. The lease term would be determined at the lease commencement date (e.g., when the asset is available to the lessee) for the noncancelable period, along with both of the following conditions:
 1. The period covered by an extension option if the lessee has a significant economic incentive to exercise that option.
 2. The periods covered by a termination option if the lessee has a significant economic incentive to exercise that option.²⁸

²⁶ Financial Accounting Standards Board. *Proposed Accounting Standards Update (Revised)*. Publication. Financial Accounting Standards Board, 16 May 2013. Web. 10 Sept. 2013. 33.

²⁷ Ernst & Young LLP. *A Closer Look at the New Lease Accounting Proposal*. Tech. Ernst & Young LLP, 23 May 2013. Web. 21 Feb. 2014. 9.

²⁸ Ernst & Young LLP. *A Closer Look*, 9.

c. Lease payments

- i. The present value of the aggregate lease payments over the lease term would be recognized as the lease liability for lessees or the lease receivable for lessors of a Type A lease (other than property lease that has higher periodic expenses at the beginning of the lease term). Lease payments would include:
 1. Fixed lease payments, less any incentives receivable from the lessor
 2. Variable payments that depend on an index or rate
 - a. The prevailing index/rate on the date of measurement would be used to consider payments
 3. In-substance fixed lease payments structured as variable lease payments
 4. Exercise price of a purchase option if lessee has significant economic incentive to exercise that option
 5. Payments for termination of a lease
 - a. If a lessee has a significant economic incentive to not terminate a lease, any termination penalty would be excluded from the lease payments, otherwise the penalty would be included in lease payments.
 6. For lessees only: amount payable under a residual value
 7. For lessors only: fixed payments structured as residual value guarantees
- ii. Variable lease payments not based on an index or rate would not be included as lease payments. An example of these payments include those based on

performance or usage (e.g., percentage of sales or number of units produced).

They would be recognized on the income statement when they are incurred.²⁹

d. Discount rate

- i. Rates would be determined on a lease-by-lease basis and used to determine the present value of the lessee payments.

ii. Lessees

- 1. Use the rate the lessor charges, if readily determined.
- 2. Lessee should use own incremental borrowing rate if rate is not known.
 - a. The incremental borrowing rate would be the rate the lessee would have to pay to borrow the funds necessary to buy an asset that is very similar to the right-of-use asset with similar payments as the lease term.

iii. Lessors

- 1. Use the rate the lessor charges the lessee (the rate implicit in the lease).
 - a. The implicit rate is the rate that causes the sum of the present value of the payments made by the lessee and the present value of the amount the lessor expects to derive from the underlying asset following the end of the lease equal to the fair value of the underlying asset.
- 2. If rate implicit is not available the property yield may be used instead.³⁰

3. Lease classification

²⁹ Ernst & Young LLP. *A Closer Look at the New Lease Accounting Proposal*. Tech. Ernst & Young LLP, 23 May 2013. Web. 21 Feb. 2014. 10.

³⁰ Ernst & Young LLP. *A Closer Look at the New Lease Accounting Proposal*. Tech. Ernst & Young LLP, 23 May 2013. Web. 21 Feb. 2014. 11.

- a. The proposal introduced classifying the new lease types based on the nature of the underlying asset. There would be two types of leases, Type A and Type B, and the difference between the two would depend on the portion of economic benefit expected to be consumed by the lessee over the lease term³¹
- i. Leases that are not property (e.g., equipment, vehicles) would be classified as a Type A lease, unless one of the following is met:
 - 1. The lease term is for an insignificant part of the total economic life of the underlying asset.
 - 2. The present value of the lease payments is insignificant relative to the fair value of the underlying asset on the date of commencement.
 - ii. Leases of property (e.g., land, building or part of a building) would be classified as a Type B lease, unless one of the following is met:
 - 1. The lease term is for a major part of the remaining economic life of the underlying asset.
 - 2. The present value of the lease payments is for substantially all of the fair value of the underlying asset on the date of commencement.
 - iii. If there is a significant economic incentive for a lessee to exercise a purchase option on a lease, it must be classified as Type A.
 - iv. Most leases involving property would be classified as Type B and most involving assets other than property would be Type A.
 - v. Reassessments of lease classification would occur only if there is a substantive modification to a contract, resulting in a new contract.

³¹ Ernst & Young LLP. *A Closer Look at the New Lease Accounting Proposal*. Tech. Ernst & Young LLP, 23 May 2013. Web. 21 Feb. 2014. 12.

- vi. The proposed guidance does not provide definitions for “major part” or “substantially all” for the exception criteria associated with property leases.

There are no bright-line tests required like there currently are for US GAAP. The distinguishing factors are more similar to the current guidance for IFRS in differentiating capital and operating leases.³²

4. Lessee accounting

- a. Lessees would be required to recognize all leases except for short term leases on the balance sheet. On the commencement date of the lease, the lessee would be required to record a liability for the lease payments and an asset to recognize the right-of-use asset in the contract. The initial recognition of the right-to-use asset and lease liability would be the same for both Type A and Type B leases, as well as the subsequent measurement for the lease liability. However, the difference in accounting would occur in the subsequent measurement of the right-to-use asset.

- b. Initial recognition and measurement

- i. Lease liability

- 1. The liability recorded would be based on the present value of lease payments to be made over the term of the lease.
 - 2. Lessees would use the concepts described in part 2 of the Proposed Lease Accounting section to determine the lease term, lease payments, and discount rate.
 - 3. Any variable rates not based on an index or rate would be excluded from the lease liability.

- ii. Right-to-use asset

³² Ernst & Young LLP. *A Closer Look at the New Lease Accounting Proposal*. Tech. Ernst & Young LLP, 23 May 2013. Web. 21 Feb. 2014. 13.

1. The right-of-use asset would be initially measured at cost based on the measurement of the lease liability plus any lease prepayments and initial direct costs like legal fees or commission.³³

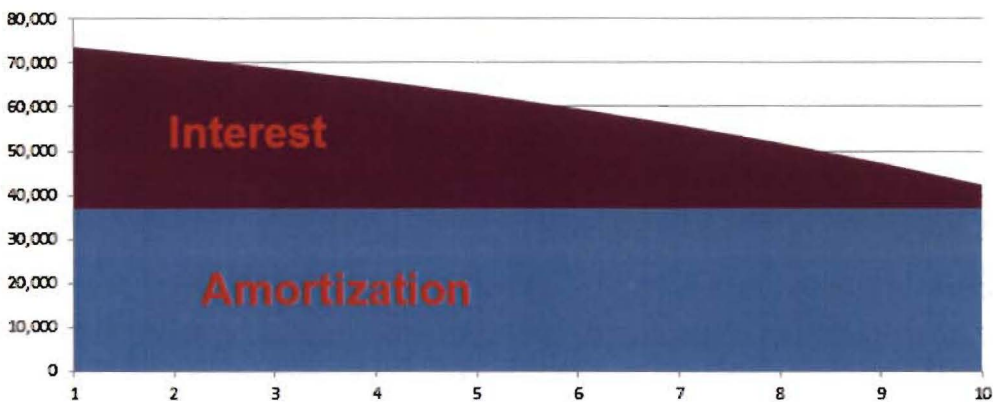
c. Subsequent measurement

- i. The lease liability for both Type A and Type B loans is accounted for using the effective interest method. When lease payments are made the liability would be reduced by that amount.
- ii. Type A Lease Assets
 1. All Type A leases would amortize the right-to-use asset on a straight-line basis, unless another basis better represents the pattern that the lessee will consume the right-of-use asset's future economic benefits. The term over which it is amortized would be the shorter of the lease term or the useful life of the right-of-use asset. If there is a significant economic incentive to exercise a purchase option, then the amortization period should be the remaining useful life of the underlying asset.
 2. The periodic expenses for Type A leases would be higher in the early periods and lower in the later periods. A consistent interest rate would be applied to the lease liability, so as cash payments are made over the term the liability decreases. This results in more interest expense being incurred in the earlier periods. So overall more total periodic expenses

³³ Ernst & Young LLP. *A Closer Look at the New Lease Accounting Proposal*. Tech. Ernst & Young LLP, 23 May 2013. Web. 21 Feb. 2014. 14.

are going to be recognized early on in Type A leases compared to Type B.³⁴

3. The illustration below is from a presentation made by Dr. James Schmutte for a Ball State Alumni Accounting and Alumni presentation in June of 2013 depicts the expense patterns of a typical Type A other than property lease. For this illustration the fair value of the equipment is \$368, 674 with an annual payment of \$60,000 at the end of the year with a 10% interest rate.³⁵



	Payment	Interest	Principal	Balance	Amortization	Interest
Initial PV	-	-	-	368,674	Straight line	-
1	60,000	36,867	23,133	345,541	36,867	36,867
2	60,000	34,554	25,446	320,095	36,867	34,554
3	60,000	32,010	27,990	292,105	36,867	32,010
4	60,000	29,210	30,790	261,315	36,867	29,210
5	60,000	26,132	33,868	227,447	36,867	26,132
6	60,000	22,745	37,255	190,192	36,867	22,745
7	60,000	19,019	40,981	149,211	36,867	19,019
8	60,000	14,921	45,079	104,132	36,867	14,921
9	60,000	10,413	49,587	54,545	36,867	10,413
10	60,000	5,455	54,545	0	36,867	5,455

³⁴ Ernst & Young LLP. *A Closer Look at the New Lease Accounting Proposal*. Tech. Ernst & Young LLP, 23 May 2013. Web. 21 Feb. 2014. 14.

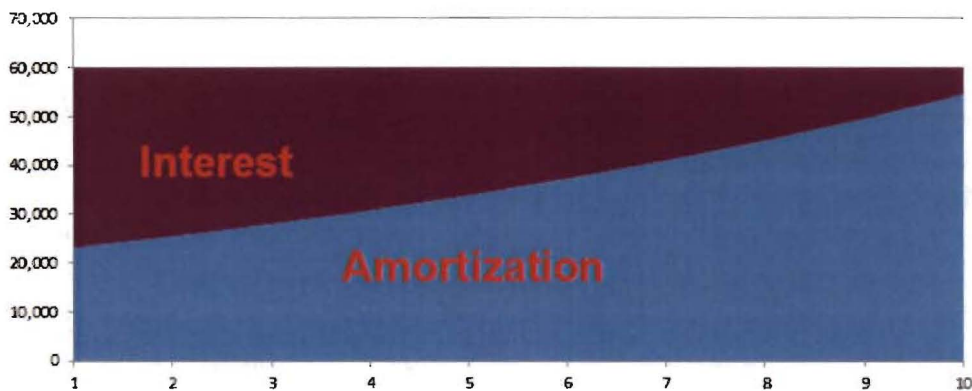
³⁵ Schmutte, James. "Ball State Alumni Accounting and Auditing." Ball State University, Muncie, IN. 26 June 2013. Lecture.

iii. Type B Lease Assets

1. For subsequent measurement of Type B leases, a single lease cost, combining the unwinding of the discount on the lease liability with the amortization of the right-of-use asset would be recognized. This would be calculated so the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis.³⁶
2. At each reporting period the remaining cost of the lease is calculated as:
 - a. Lease payments (that were determined at the commencement date of the lease); plus
 - b. Initial direct costs (again determined at the lease commencement date); minus
 - c. Periodic lease recognized in prior periods; minus
 - d. Any impairment of the right-of-use asset recognized in prior periods; plus or minus
 - e. Any adjustments that have been made to the lease liability through remeasurement.
3. When the remaining cost of the lease is greater than the periodic interest taken on the lease liability, the change in the right-of-use asset is calculated as the difference between the periodic straight-line expense amount and the accretion of the lease liability. There would be no adjustment to the right-of-use asset if the periodic interest expense on the lease liability is higher than the remaining cost of the lease.

³⁶ Financial Accounting Standards Board. *Proposed Accounting Standards Update (Revised)*. Publication. Financial Accounting Standards Board, 16 May 2013. Web. 10 Sept. 2013. 59.

4. Calculations would need to be made each accounting period to adjust for any changes in the right-of-use assets.³⁷
5. The following illustration for the Type B property lease is from the same presentation that the Type A expense pattern illustration displayed in subsection ii) was from. For this illustration, the fair value of the building is \$368,674, the annual payment is \$60,000 at the end of each year, and the interest rate is 10%.³⁸



	Payment	Interest	Principal	Balance	Amortization	Interest
Initial PV	-	-	-	368,674	"plug"	-
1	60,000	36,867	23,133	345,541	23,133	36,867
2	60,000	34,554	25,446	320,095	25,446	34,554
3	60,000	32,010	27,990	292,105	27,990	32,010
4	60,000	29,210	30,790	261,315	30,790	29,210
5	60,000	26,132	33,868	227,447	33,868	26,132
6	60,000	22,745	37,255	190,192	37,255	22,745
7	60,000	19,019	40,981	149,211	40,981	19,019
8	60,000	14,921	45,079	104,132	45,079	14,921
9	60,000	10,413	49,587	54,545	49,587	10,413
10	60,000	5,455	54,545	0	54,545	5,455

³⁷ Ernst & Young LLP. *A Closer Look at the New Lease Accounting Proposal*. Tech. Ernst & Young LLP, 23 May 2013. Web. 21 Feb. 2014. 16.

³⁸ Schmutte, James. "Ball State Alumni Accounting and Auditing." Ball State University, Muncie, IN. 26 June 2013. Lecture.

d. Reassessment

- i. After the commencement of the lease, lessees would monitor the leases for any changes in consideration that could possibly prompt a reassessment of the lease liability. If reassessment was decided to be necessary, the lease liability would be remeasured. If any of the following were expected to change, there would be revised inputs at the date of reassessment:

- 1. Factors that result in change to the lease term including when a lessee now has or no longer has significant economic incentive to do any of the following:
 - a. Exercise an already existing option to extend the lease or to purchase the underlying asset
 - b. Not exercise an existing option to terminate a lease
- 2. Amounts payable under residual value guarantees
- 3. An index or rate used to determine lease payments during the reporting period, using the index or rate at the end of the reporting period

- ii. Lessees need to focus on certain factors to decide if the lease term has changed, these factors include asset-, contract-, and entity-based factors. They also include market-based factors but not in isolation:

- 1. Purchase option or lease renewal option and the related pricing
- 2. Termination option and the amount of payments for termination or nonrenewal
- 3. Amounts due for residual value guarantees
- 4. Costs of returning asset in specified condition or location
- 5. Economic penalties such as significant customization or relocation costs

- iii. Lessees would also reassess the lease if they had decided to renew a lease when they had previously decided they would not renew it.
- iv. Discount rates would be reassessed only if changes were to occur to the following:
 - 1. The lease term.
 - 2. Factors that result with the lessee to have or no longer have a significant economic incentive to exercise a purchase option.
 - 3. An interest rate used to determine lease payments.³⁹

e. Presentation

i. Balance Sheet

1. Both types of lease

- a. Right-of-use assets and lease liabilities for both types would be presented separately from other assets and liabilities, or they would be disclosed separately in the notes. Balance sheet line items that contain right-of-use assets and lease liabilities would be disclosed in the notes.
- b. If right-of-use assets are combined with any other assets that aren't included in leasing, they need to be grouped with assets that would present the underlying assets as if they were owned.

ii. Income Statement

1. Type A:

- a. Lease related amortization and any interest expense would be presented separately.

³⁹ Ernst & Young LLP. *A Closer Look at the New Lease Accounting Proposal*. Tech. Ernst & Young LLP, 23 May 2013. Web. 21 Feb. 2014. 18.

2. Type B:

- a. Lease-related expenses would be presented as a single line of lease or rent expense.

iii. Statement of Cash Flows

1. Type A:

- a. Any cash payments for the principal portion of the lease would be presented in the financing activities section. Interest payments would be presented in accordance with ASC 230, *Statement of Cash Flows*, in which interest payments are included in operating activities.

2. Type B:

- a. Any cash payments for lease payments are presented under the operating activities section.

3. For both types:

- a. Short-term leases and variable lease payments would be included under the operating activities section.
- b. Any noncash activity would be disclosed as a supplemental noncash item.⁴⁰

Other Topics

5. Substantive substitution rights

- a. Substitution rights give the supplier the right to supply the lessee with an alternate asset for the agreement. If the supplier in a lease agreement has substantive substitution

⁴⁰ Ernst & Young LLP. *A Closer Look at the New Lease Accounting Proposal*. Tech. Ernst & Young LLP, 23 May 2013. Web. 21 Feb. 2014. 20.

rights it would not need to depend on the use of an identified asset, and for substitution rights to be considered substantive they must meet the following criteria:

- i. An alternative asset can be supplied by supplier without first getting consent of the customer
- ii. There are no barriers present that would stop the supplier from being able to supply an alternative asset, similar to:
 1. Costs for substituting are so high that they create a disincentive to substitute.
 2. Operational barriers, for example alternatives aren't available.
- iii. If substitution by supplier is only permitted when the asset isn't properly functioning this would not be considered substantive.⁴¹

6. Cancelable leases

- a. Some leases that are considered "cancelable" are subject to the proposal if the agreement creates enforceable rights and obligations. A lease would meet the definition of a contract if a renewal option were available or another type of enforceable obligation. If the agreement allows for the lessor and the lessee to terminate the lease without the permission of the other party and without penalty, it is not enforceable.⁴²

7. Changes made to contracts

- a. If a modification to a contract is substantive, it would result in a new contract at the date the modification went into effect. It would also require an assessment as to whether a contract is considered a lease.

⁴¹ Ernst & Young LLP. *A Closer Look at the New Lease Accounting Proposal*. Tech. Ernst & Young LLP, 23 May 2013. Web. 21 Feb. 2014. 4.

⁴² Ernst & Young LLP. *A Closer Look at the New Lease Accounting Proposal*. Tech. Ernst & Young LLP, 23 May 2013. Web. 21 Feb. 2014. 6.

- i. Substantive modifications include changes to the contractual lease term or the amount of contractual payments when the conditions were not a part of the original contract.
- b. If modifications of a lease agreement cause any differences in the carrying amounts of the lease-related assets and liabilities those differences should be recognized in profit or loss.⁴³

8. Disclosure

- a. Many more disclosures (both qualitative and quantitative in nature) would need to be made to help users better understand the nature and amount of leases the company is holding. For public companies, a separate reconciliation of opening and closing balances for both Type A and B leases would be required among other disclosures.⁴⁴

⁴³ Ernst & Young LLP. *A Closer Look at the New Lease Accounting Proposal*. Tech. Ernst & Young LLP, 23 May 2013. Web. 21 Feb. 2014. 8.

⁴⁴ Ernst & Young LLP. *A Closer Look*, 21.

Exposure Draft Comment Letter Summary

Overview

So many letters were received that a summary of the major concerns was drafted and released in late November.⁴⁵ The comment letter concerns that were focused on for this paper focused on the lessee model, classification of leases, and implementation of the proposed changes. These areas were chosen because they are the most relevant to what undergraduate students will be studying in accounting courses, and therefore the most relevant at this point in their education. Comments that support and provide alternative suggestions are also listed in addition to concerns that were mentioned on these topics. The sources cited include the entirety of information on comment letter topics that hits almost all parts of the 2013 Exposure Draft. In addition to summaries of comment letters, there are illustrations on the demographic information on those who wrote in to comment on the Exposure Draft.

1. Lessee model

- a. Most of the companies that wrote into the comment letters agreed that there was a need for the lessee model of accounting to change for three main reasons:
 - i. Financial positions of the lessee are not accurately reflective with the current treatment.⁴⁶
 - ii. Users are not equipped with adequate information in disclosures to make adjustments.⁴⁷
 - iii. Currently a very similar economic transaction can be accounted for very differently.⁴⁸

⁴⁵ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback on the 2013 ED*. Publication. IFRS Foundation and Financial Accounting Standards Board, Nov. 2013. Web. 21 Dec. 2013.

⁴⁶ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 7.

⁴⁷ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 7.

- b. Some constituents argue that a change is not needed because:
 - i. The current lease accounting treatment is very well understood and notes in the financial statements provide adequate information for any user to make required adjustments.⁴⁹
 - ii. Users make adjustments for many different reasons and no one single model will prevent the need for users to make adjustments.⁵⁰
 - iii. The benefits of changing the lessee accounting model would not outweigh the costs that would be required to implement it.⁵¹
- c. Balance Sheet Revisions
 - i. In support
 - 1. Credit and equity analysts are for the most part in favor of these changes because of the better information the new model would provide in relation to credit risk by requiring the recognition of an asset and liability for leases.⁵²
 - 2. Other constituents including regulators, standard setters, accounting firms, and some preparers support the proposal for the right-of-use asset because it gives a more accurate representation of leverage and assets used by the lessee.⁵³
 - ii. Concerns: On the other hand, there were concerns of the lessee's model to recognize a right-of-use asset and a lease liability.

⁴⁸IFRS Foundation and FASB Staff. *Leases: Summary of Feedback on the 2013 ED*. Publication. IFRS Foundation and Financial Accounting Standards Board, Nov. 2013. Web. 21 Dec. 2013. 7.

⁴⁹ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 7.

⁵⁰ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 7.

⁵¹ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 7.

⁵² IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 8.

⁵³ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback on the 2013 ED*. Publication. IFRS Foundation and Financial Accounting Standards Board, Nov. 2013. Web. 21 Dec. 2013. 9.

1. Some users believe that one model cannot provide a complete picture for the nature of leases and the best alternative is to enhance disclosure requirements.⁵⁴
2. Some are concerned with how lease assets and liabilities will be measured based on contractual commitments and are more interested in whole asset information (how much would be capitalized if it were purchased instead of leased) or in perpetual information (the level of debt needed to continue operations on a similar basis).⁵⁵
3. Some criticized the accounting for the Type B lessee model:
 - a. The amortization method is different from any other method used for nonfinancial assets and isn't reflective of its actual use by the lessee.⁵⁶

d. Income Statement Revisions

i. In support

1. Many agree that the dual method for income statement presentation for lessees is an improvement that helps to reflect the different economics for different types of leases for the following reasons:
 - a. They understand the rationale for a dual approach in the lessee's income statement because of the differences between property and other than property leases.⁵⁷

⁵⁴ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 9.

⁵⁵ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 9.

⁵⁶ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 11.

⁵⁷ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback on the 2013 ED*. Publication. IFRS Foundation and Financial Accounting Standards Board, Nov. 2013. Web. 21 Dec. 2013. 12.

- b. Some analysts (mainly airline and transport analysts) agree with the portion of the proposal to present amortization and interest expense separately in order to show consistency between owned and leased assets.⁵⁸
- c. Other users agree with this dual model because they think that it properly reflects what a lessee pays for consuming the asset separately from what it pays for financing it.⁵⁹

2. Concerns

- a. A majority disagree with the dual model based on the consumption of the underlying asset.⁶⁰
- b. Some would prefer that Type A accounting should be applied to all lease types so amortization and interest expense would be recognized separately for all leases. Most credit analysts and the two credit rating agencies were in support of this.⁶¹
- c. Some are concerned that the dual model will extend the risk of structuring to gain a particular outcome—one of the major criticisms of the existing model.⁶²
- d. Others disagree with the way the classification decisions are made with the dual model because they believe the consumption principle isn't as well understood, doesn't as accurately capture the economic differences between leases,

⁵⁸ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 12

⁵⁹ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 13.

⁶⁰ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 13.

⁶¹ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 13.

⁶² IFRS Foundation and FASB Staff. *Leases: Summary of Feedback on the 2013 ED*. Publication. IFRS Foundation and Financial Accounting Standards Board, Nov. 2013. Web. 21 Dec. 2013. 14.

and it isn't as closely tied to commercial, bankruptcy, and income tax systems.⁶³

- e. Many constituents brought up concerns with the cost and complexities of implementing the dual model because new accounting systems would need to be set up and there would be a lot more professional judgment needed in order to appropriately classify a lease.⁶⁴
- f. Some constituents also expressed a concern on the income statement profile for the Type A leases in particular, including concerns with both:
 - i. The front-loaded expense profiles⁶⁵
 - ii. The switch to presenting a separate interest and amortization expense from a rental expense for equipment leases currently classified as operating leases.⁶⁶
- g. Other concerns were raised about the income statement profile for the Type B leases. These disagreements stem from the required lease liability in the balance sheet that must be recognized while no interest expense is recognized which may

⁶³ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 14.

⁶⁴ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 14.

⁶⁵ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 15.

⁶⁶ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback on the 2013 ED*. Publication. IFRS Foundation and Financial Accounting Standards Board, Nov. 2013. Web. 21 Dec. 2013. 15.

lead to discrepancies in ratios used to assess operations.⁶⁷ Other suggestions for improving or changing the Type B leases include:

- i. Separately presenting interest and amortization expense⁶⁸
- ii. Presenting full rent expense as interest expense⁶⁹
- iii. Applying Type A accounting, but presenting interest and amortization expense as a single rent expense.⁷⁰
- iv. Other constituents suggested that if the Board were to continue with the dual model then entities should be able to decide to account for the leases all in the same way as either Type A or Type B.⁷¹

2. Classification of Lease Type

a. In support

- i. Some constituents support the classification guidance in the 2013 Exposure Draft because they believe it “offers a core principle” and “an operational way to apply that principle.” These comments are referring to the classification that is based on consumption of the underlying asset and the nature of the underlying asset.⁷²

b. Concerns

⁶⁷ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 15.

⁶⁸ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 16.

⁶⁹ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 16.

⁷⁰ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 16.

⁷¹ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 16.

⁷² IFRS Foundation and FASB Staff. *Leases: Summary of Feedback on the 2013 ED*. Publication. IFRS Foundation and Financial Accounting Standards Board, Nov. 2013. Web. 21 Dec. 2013. 26.

- i. Most constituents have concerns with subjective language used in the Exposure Draft, for example, “insignificant,” “major part,” and “substantially all.” They believe these terms alone will lead to inconsistency.⁷³
- ii. Other concerns deal with the two-tiered system for classification:
 1. Some disagree for the lease classification to depend on the nature of the asset in a right-of-use model.⁷⁴
 2. “The application of the consumption principle on the basis of comparing the present value of lease payments to the fair value of the underlying asset and/or comparing the lease term to the economic life of the underlying asset.” There is apprehension that similar leases involving the same underlying asset would be able to be classified in different ways.⁷⁵
- iii. Some consider the definition of “property” in the Exposure Draft too narrow.⁷⁶
- iv. Some areas of specific concern in the exposure draft relating to classification include:
 1. Leases of land and building. Some think that land and building elements should be separate. Others believe that the remaining economic life of the building shouldn’t be used to classify the lease.⁷⁷
 2. Leases with the right to use more than one asset. Some think there should be more guidance on the determination of the “primary asset.” Others do not support the primary asset concept.⁷⁸

⁷³ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 26.

⁷⁴ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 26.

⁷⁵ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 26.

⁷⁶ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 27.

⁷⁷ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback on the 2013 ED*. Publication. IFRS Foundation and Financial Accounting Standards Board, Nov. 2013. Web. 21 Dec. 2013. 27.

3. Economic life. Some disagree that remaining economic life is used to classify property leases, while total economic life is used for leases other than property, suggesting that total economic life be used for classifying all lease types. They disagree that the type of lease can change from Type B to Type A as the asset ages if remaining life of underlying asset is depended on.⁷⁹
4. Fair value. Some disagree with using fair value of the underlying asset to classify leases because it is difficult to determine for some assets.⁸⁰
5. Reassessment of classification. “Some constituents disagree with the prohibition against reassessing lease classification.” They believe this could lead to structuring of leases to include features like extensions to be classified as Type B instead of Type A.⁸¹

c. Other Suggestions

- i. Classification based solely on underlying assets (all property as Type B and all other than property as Type A).⁸²
- ii. Classification based solely on consumption.⁸³
- iii. Changing the classification guidance in a way to prevent any property leases from becoming Type A leases, and any other than property from being classified as a Type B.⁸⁴

⁷⁸ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 27.

⁷⁹ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 27.

⁸⁰ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 27.

⁸¹ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback on the 2013 ED*. Publication. IFRS Foundation and Financial Accounting Standards Board, Nov. 2013. Web. 21 Dec. 2013. 27.

⁸² IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 28.

⁸³ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 28.

⁸⁴ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 28.

- iv. To expand the definition of property to include “integral equipment” which is included under the current Topic 840. The constituents that suggested it believe that telecommunication towers, fiber-optic cables, and pipelines should be incorporated in an expanded definition.⁸⁵
- v. Additional guidance in regard to specific terms including but not limited to “economic life,” “insignificant,” “major,” and “substantially all.”⁸⁶
- vi. The use of bright-line tests instead of using terms like “insignificant” and “major.”⁸⁷
- vii. More application guidance.⁸⁸

3. Implementation

- a. Concerns with internal functions:
 - i. Having to update IT systems by investing in new systems just for compiling leasing data and financial statement information.⁸⁹
 - ii. Collecting lease data. A great amount of time and resources would need to be put to work in order to compile all of the information needed to implement the proposals.⁹⁰
 - iii. Educating personnel. This would be the next step after collecting all of the necessary data.⁹¹

⁸⁵ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 28.

⁸⁶ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 28.

⁸⁷ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 28.

⁸⁸ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 28.

⁸⁹ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback on the 2013 ED*. Publication. IFRS Foundation and Financial Accounting Standards Board, Nov. 2013. Web. 21 Dec. 2013. 58.

⁹⁰ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 58.

⁹¹ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 58.

- iv. Design and implementation of new controls would be necessary to ensure reliable financial information.⁹²
 - v. Additional personnel. Many think that they would need to hire additional personnel to implement the proposals, and others think they would be needed on a permanent basis in addition to implementation purposes.⁹³
 - vi. Educating investors. Some are concerned with the costs of needing to educate investors of these changes that vary majorly from the existing requirements in relation to leases. They are especially concerned with the costs and efforts of having to supply additional non-GAAP information for investors per their requests.⁹⁴
- b. Other externally focused concerns:
- i. Regulatory impacts. Banks have concerns with how the proposals would affect regulatory capital requirements and calculations. Other entities have shown concern about the costs to produce regulatory reporting on a different basis.⁹⁵
 - ii. Debt covenants. A lot of constituents are concerned with the increase in lease liabilities on the balance sheet affecting debt covenants that could possibly put them into default or at least having to renegotiate contract terms with their banks resulting in fees. Constituents concerned with this also emphasize the need for the Board to reach out to the banking industry before the proposals are issued.⁹⁶

⁹² IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 58.

⁹³ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 58.

⁹⁴ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 58.

⁹⁵ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback on the 2013 ED*. Publication. IFRS Foundation and Financial Accounting Standards Board, Nov. 2013. Web. 21 Dec. 2013. 59.

⁹⁶ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 59.

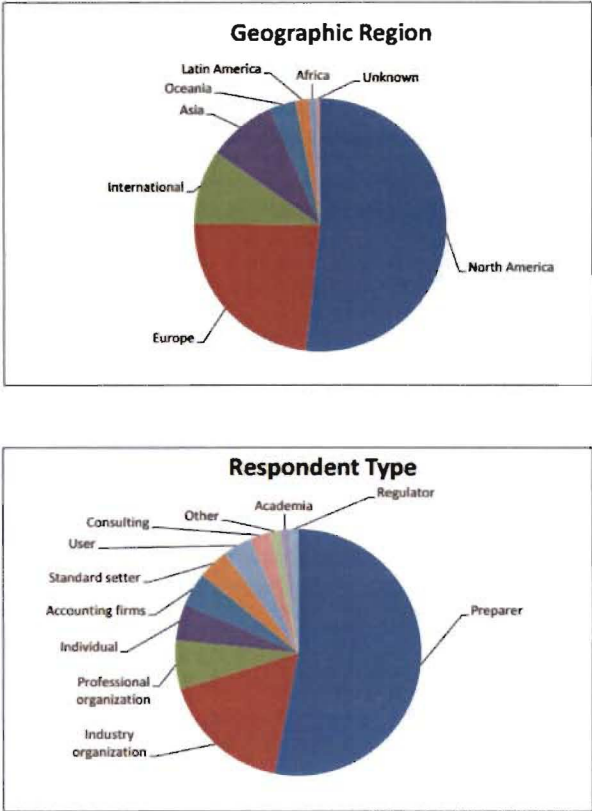
- iii. Tax implications. Some are concerned that this change will require the need to keep a set of lease records for both tax and financial reporting purposes if there is no amendment to tax rules that will align with the proposed lease accounting.⁹⁷
- iv. Bankruptcy implications. Again constituents are concerned that the proposed lease accounting would not align with the present bankruptcy regulations.⁹⁸
- v. Professional services fee. Some are worried about the increased costs for auditors and consultants when the proposals would first be implemented and also on an on-going basis to pay for increased audit fees, and tax services to deal with reporting differences between the books and taxes.⁹⁹

⁹⁷ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 59.

⁹⁸ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 59.

⁹⁹ IFRS Foundation and FASB Staff. *Leases: Summary of Feedback*, 59.

4. Demographic Information of Comment Letters¹⁰⁰



¹⁰⁰ Pie Charts: IFRS Foundation and FASB Staff. *Leases: Summary of Feedback on the 2013 ED*. Publication. IFRS Foundation and Financial Accounting Standards Board, Nov. 2013. Web. 21 Dec. 2013. 76.

Comments from Big Four Firms

Many public accounting and consulting firms have issued articles and newsletters detailing some of the upcoming changes that may be occurring in regards to lease accounting. All of the Big Four firms have concerns on the current proposals under consideration, mainly focused on the information provided not being improved while causing preparers an extreme adjustment in cost and complexity of implementing the proposal. Although they may not agree with the entirety of the proposals, to keep their clients in mind they have been giving advice on proactive steps that can be taken in order to help ease the transition if the new proposals are passed. The following includes opinions on the proposal by the Big Four firms, and also impacts that they believe this accounting change may have on companies if the new standard is passed.

EY openly expressed that they do not support the proposal in their comment letter while they still stated they continue to support the efforts to improve lease accounting to provide greater transparency in financial reporting. They acknowledge that the exposure draft does address the main criticism of the current treatment by requiring lessees to recognize assets and liabilities that are created by leases but they are unsure of how the new system would improve the comparability of different companies or reduce necessary adjustments.¹⁰¹ They also do not believe that the new criteria for lease classification is an improvement on the current basis stating that it does not solve the criticism that similar transactions receive different accounting treatment. They express the view that the new guidance would just make the dividing lines of classification unfamiliar and add new complexity in the

¹⁰¹ Ernst & Young Global Limited. "Invitation to Comment - Exposure Draft Leases." Letter to International Accounting Standards Board; Financial Accounting Standards Board. 13 Sept. 2013. *EY.com*. Ernst & Young, 13 Sept. 2013. Web. 27 Feb. 2014. 1.

place of an old one.¹⁰² In regards to lessee accounting, they support recognizing assets and liabilities on the balance sheet created from leases if done in a practical manner that provides financial statement users with improved and relevant information to make better decisions, however they have difficulty understanding the conceptual basis for the accounting for Type B leases. EY states that “The Boards note that financial statement users have indicated a preference for an approach that results in straight-line expense recognition for certain leases. We therefore believe the Boards should acknowledge that the Type B approach is a compromise to provide relevant users with information requested rather than attempt to create a conceptual justification that cannot be supported.”¹⁰³ They went on to comment on how guidance on additional topics needed to be better articulated and that they would only support proposals in which the benefits to financial statement users would justify the costs to implement them.¹⁰⁴ However, at this point it is not clear to how users would benefit from these changes.

According to the comment letter by PwC, they state that a single ‘right-of-use’ model for all leases might be too complex to apply in some circumstances and will in effect reduce the usefulness of financial statements to users. They do agree with the boards in that different types of leases should be accounted for differently, but they find the consumption based principle to be heavily lessor-focused and irrelevant for many lessees.¹⁰⁵ They also find that proposed classification guidance does not improve on the current distinctions used, and that the current criteria of International Accounting Standard 17 should be incorporated into the proposal instead of the consumption principle. Additionally they find

¹⁰² Ernst & Young Global Limited. "Invitation to Comment - Exposure Draft Leases." Letter to International Accounting Standards Board; Financial Accounting Standards Board. 13 Sept. 2013. *EY.com*. Ernst & Young, 13 Sept. 2013. Web. 27 Feb. 2014. 5.

¹⁰³ Ernst & Young Global Limited. "Invitation to Comment - Exposure Draft Leases." Letter to International Accounting Standards Board; Financial Accounting Standards Board. 13 Sept. 2013. *EY.com*. Ernst & Young, 13 Sept. 2013. Web. 27 Feb. 2014. 6.

¹⁰⁴ Ernst & Young Global Limited. "Invitation to Comment - Exposure Draft Leases." Letter to International Accounting Standards Board; Financial Accounting Standards Board. 13 Sept. 2013. *EY.com*. Ernst & Young, 13 Sept. 2013. Web. 27 Feb. 2014. 8.

¹⁰⁵ PricewaterhouseCoopers International Limited. "Exposure Draft: Leases." Letter to International Accounting Standards Board and Financial Accounting Standards Board. 12 Sept. 2013. *Pwc.com*. PricewaterhouseCoopers International Limited, 12 Sept. 2013. Web. 27 Feb. 2014. 1.

that classifying leases based on whether it is 'property' to not be neutral.¹⁰⁶ They also commented on the difficulties that could arise from the draft's narrow definition of property. They believe this will especially pose a problem when trying to determine a primary asset in a multiple element arrangement.¹⁰⁷ PwC's opinion aligns with EY's in that it is not clear that the costs incurred through implementing standard changes will be worth the benefits provided through the proposal.

Deloitte is also concerned like many other respondents about the costs and complexities for preparers of interpreting and applying the changes that would occur. Their major concerns fall within the dual model complexity, inconsistent accounting for leases that may be economically similar, and the opportunities for accounting arbitrage that could occur with the change in standard.¹⁰⁸ In regards to the dual model, they too are unsure of the merit in the accounting for Type B leases and are concerned with the proposition to recognize an increasing amount of amortization over the term of the lease. They too discuss the need for additional guidance on defining 'property' and how currently the definition may result in significantly different measurements and presentation for leases that are similar and opportunities for accounting arbitrage.¹⁰⁹ In relation to the lessee model proposed, they believe that the issue of accounting for similar leases differently is aggravated rather than resolved by the proposal.

¹⁰⁶ PricewaterhouseCoopers International Limited. "Exposure Draft: Leases." Letter to International Accounting Standards Board and Financial Accounting Standards Board. 12 Sept. 2013. *Pwc.com*. PricewaterhouseCoopers International Limited, 12 Sept. 2013. Web. 27 Feb. 2014. 2.

¹⁰⁷ PricewaterhouseCoopers International Limited. "Exposure Draft: Leases." Letter to International Accounting Standards Board and Financial Accounting Standards Board. 12 Sept. 2013. *Pwc.com*. PricewaterhouseCoopers International Limited, 12 Sept. 2013. Web. 27 Feb. 2014. 6.

¹⁰⁸ Deloitte Touche Tohmatsu Limited. "IASB Exposure Draft ED/2013/6 / FASB File Reference No. 2013-270." Letter to International Accounting Standards Board and Financial Accounting Standards Board. 13 Sept. 2013. *lasplus.com*. Deloitte Touche Tohmatsu Limited, 13 Sept. 2013. Web. 27 Feb. 2014. 1.

¹⁰⁹ Deloitte Touche Tohmatsu Limited. "IASB Exposure Draft ED/2013/6 / FASB File Reference No. 2013-270." Letter to International Accounting Standards Board and Financial Accounting Standards Board. 13 Sept. 2013. *lasplus.com*. Deloitte Touche Tohmatsu Limited, 13 Sept. 2013. Web. 27 Feb. 2014. 2.

They note that the issues have stemmed from the use of the bright lines and dual classification, but they do not perceive the suggested method to solve any of these existing problems.¹¹⁰

KPMG also shares many of the same opinions of the other Big Four firms, and they do not support the Boards issuing a final standard based on the current exposure draft.¹¹¹ The main areas of concern for KPMG are that: (1) the proposals will not increase the relevance of, or eliminate the adjustments that users make to financial statements, (2) the proposals are complex and will be costly for preparers to implement, and (3) there is no conceptual basis for key aspects of the proposals and many are inconsistent with the Boards' conceptual frameworks. KPMG also expressed their views on the lack of consensus amongst constituents about the proposal and the direction of the project.¹¹² They also commented that the proposals seem designed to facilitate an increase in adjustments by users, rather than to help eliminate current adjustments. They conclude that if the amount of necessary adjustments by users is not decreased by the proposals, the accounting changes cannot be considered more useful and therefore the benefits of the changes do not outweigh the costs. KPMG believes the next steps for the project should be to re-articulate the essential attributes of an improved lease accounting standard, and to identify the lease accounting model(s) that could form the basis of a lease accounting standard with those essential attributes.¹¹³

In a recent publication by PwC, the importance of changes in lessee accounting will cause for multiple areas of the business are stressed. They mention that not only will this be a change in accounting, but it will also affect many financial measures and business processes. With the change in

¹¹⁰ Deloitte Touche Tohmatsu Limited. "IASB Exposure Draft ED/2013/6 / FASB File Reference No. 2013-270." Letter to International Accounting Standards Board and Financial Accounting Standards Board. 13 Sept. 2013. *lasplus.com*. Deloitte Touche Tohmatsu Limited, 13 Sept. 2013. Web. 27 Feb. 2014. 7.

¹¹¹ KPMG IFRG Limited. "Comment Letter on Exposure Draft, Leases." Letter to International Accounting Standards Board and Financial Accounting Standards Board. 12 Sept. 2013. *kpmg.com*. KPMG IFRG Limited, 12 Sept. 2013. Web. 27 Feb. 2014. 2.

¹¹² KPMG IFRG Limited. "Comment Letter on Exposure Draft, Leases." 2.

¹¹³ KPMG IFRG Limited. "Comment Letter on Exposure Draft, Leases." 4.

accounting, EBITDA, net income and operating cash flows will be different. The changes in these measures will likely impact loan covenants and credit ratings. In regards to business processes, changes could occur not only in finance and accounting, but also IT, procurement, tax, treasury, legal, operations, corporate real estate and HR.¹¹⁴ PwC urges companies to be proactive about the possible changes, and not to wait until the standard is finalized to start assessing impacts. They urge companies assess the potential impact and to get every function on board by educating leaders. They also encourage companies to gather data on existing leases, and to assess whether changes in new systems will be necessary. Constituents are also advised to consider the ongoing re-evaluations for compliance that will be required if the standard is passed.¹¹⁵

¹¹⁴ *In Brief: Leasing Project Deliberations Settle Some Issues, but Differences Remain*. Issue brief. PricewaterhouseCoopers, 20 Mar. 2014. Web. 21 Mar. 2014.

¹¹⁵ PricewaterhouseCoopers LLP. *10 Minutes on Lease Accounting*. Publication. PwC LLP, 4 June 2013. Web. 27 Dec. 2013. 5.

Conclusion

As presented throughout the sections of Proposed Accounting for Leasing, the Exposure Draft Comment Letter Summary, and Comments from Big Four Firms, the proposal on lease accounting has created great debate within the business community. The lease project has attracted widespread attention throughout the financial reporting community, and businesses are staying keyed in on the latest deliberations from the Boards. The most recent meeting took place on March 18-19, 2014 where the Boards discussed the lessee accounting model, the lessor accounting model, small ticket leases, lease term, and short-term leases.¹¹⁶ While the FASB decided on a dual model for lessee accounting in which the classification of leases would be either Type A or Type B, the IASB decided on a single approach for lessee accounting. The lessee would account for all leases as Type A leases. The next steps of the project will be for the staff of the Boards to perform additional analysis regarding the recognition and measurement exemption of leases of small assets for lessees. The Boards plan to continue their joint redeliberations of the Exposure Draft at a future board meeting.¹¹⁷

As this proposal is continued to be discussed among the Boards and the financial reporting community, this paper can be used as a tool for undergraduate students to be exposed to some of the changes that could possibly be taking effect as they graduate and begin careers in the accounting industry. Students can use this resource to compare current and proposed accounting treatment for the way lessees will classify and record leases. Additionally, they can gain an understanding on the key issues financial statement users and preparers have with the current method for lease accounting and the concerns constituents have with the current proposed methods. Overall, this paper can subject

¹¹⁶ "FASB, Financial Accounting Standards Board." Leases-Joint Project of the IASB and FASB. N.p., n.d. Web. 22 Apr. 2014.

¹¹⁷ "FASB, Financial Accounting Standards Board." Leases-Joint Project of the IASB and FASB. N.p., n.d. Web. 22 Apr. 2014.

students to take an interest in current accounting news that will have an impact on their future accounting knowledge and careers.

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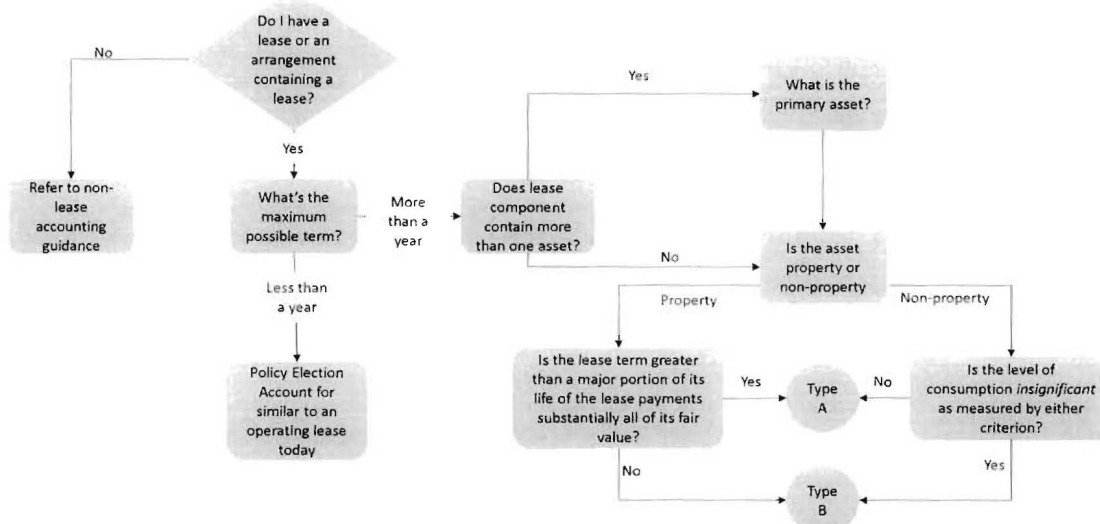
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Lease Accounting Proposal

What's New

- Classification criteria
- Nearly all leases will appear on the balance sheet as either:
 - Type A lease (not property: equipment, aircraft, cars, trucks, etc.)
 - Type B lease (property: land and/or building or part of a building)
- No more bright-line tests
- Consumption principle
- Reassessment

Classification Guidance



Source: PricewaterhouseCoopers LLP. *10 Minutes on Lease Accounting*. Publication. PwC LLP, 4 June 2013. Web. 27 Dec. 2013.

Initial Recognition

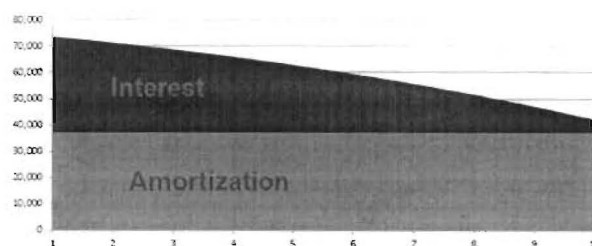
- Lease liability
 - Based on present value of lease payments to be made over lease term
- Right-of-use asset
 - Measured at cost based on the measurement of the lease liability plus any lease prepayments and initial direct costs like legal fees or commission

Subsequent Measurement

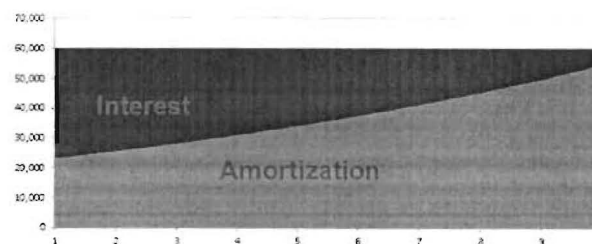
- Type A
 - Amortize on a straight-line basis or another systematic basis that reflects the pattern in which the lessee will consume the right-of-use asset
 - Consistent interest rate applied to lease liability so periodic expenses at the beginning of the lease would be higher than near the end
- Type B
 - Measure lease liability on an amortized cost basis and amortize right-of-use asset each period
 - Total lease cost is recognized on a straight-line basis over the lease term

Comparison of Expense Patterns

- Type A
Other than
Property Lease



- Type B
Property Lease



Concerns by users, preparers, and others

- Lessee Model
 - Amortization method for Type B results in higher amortization in later years of lease term
 - Consumption principle found to be lessor-focused and irrelevant for lessees
- Classification Criteria
 - Believe subjective language will lead to inconsistency in comparison to existing bright-lines

Concerns, cont.

- Reasons for proposing new standard are not met
 - The problem of economically similar leases being accounted for differently isn't solved—just aggravated
 - No improvement on information to financial statement users
- Internal implementation
 - Costs to update systems, educate personnel, design and implementation of new controls
- External implementation
 - Regulatory impacts (banking), debt covenants, increased professional service fees